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INVESTMENT MANAGEMENT

Point of View

The Flattening Yield Curve: We Care, but are Not Worried

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AUTHORS

JIM CARON
Managing Director
Global Fixed Income Team

ANTON HEESE
Executive Director
Global Fixed Income Team

The U.S. yield curve has been flattening and that has generated concern from many investors because flattening curves have been associated with a signal prelude to a recession. While historically one can draw this parallel, we think it is always important to understand *why* the curve is flattening, to interpret better the signal it may be sending.

Why is the yield curve flattening?

The yield curve is flattening because the U.S. Federal Reserve (Fed) has been increasing front end policy rates since December 2015. The rise in front end policy rates has occurred during a period when inflation has been low and below the 2% target as measured by core personal consumption expenditures (PCE). Only recently has inflation risen to target levels. The combination of rising policy rates during a period of low and contained inflation is a natural impetus for a flatter curve. Said differently, under these described conditions, the path of least resistance is for a flatter curve.

What differences should we consider today about the curve flattening versus history?

FED IS INCREASING RATES, NOT TIGHTENING POLICY. This is an important distinction, because a tightening policy is designed to slow down growth and it is a very common tactic for the Fed to overshoot tightening and slow the economy more aggressively as an insurance policy to thwart inflation.

FED HAS NOT INDICATED IT WILL TIGHTEN POLICY ANYTIME SOON. Currently, the Fed's objective is to move to a neutral policy rate, not restrictive, as long as inflation does not materially rise above 2%, which thus far is not a concern. Inflation has remained very subdued, throughout the post-09 economic recovery, even as the labor market has tightened and estimates of economic slack have reduced.

UNUSUALLY SHORT AND SMALL RATE HIKE CYCLE. Current expectations of the market and the Fed are that short term interest rates are not expected to rise much after the next 18 months. This would make the current hiking cycle a very unusual one. First, the Fed has raised rates on average three times a year, which is a lot slower than recent interest rate cycles, where 8 rate hikes a year was normal.[1] Second, if the cycle ends when currently priced, it would have been a far smaller one than usual, with the federal funds rate only increasing 200 basis points (bps), vs. 425 bps in 2004-06, and 300 bps in 1994-95.[2]

MONETARY POLICY HAS KEPT TERM PREMIA[3] VERY LOW. Quantitative easing (QE) was designed to depress the term premia of the yield curve and that has the effect of reducing long-term interest to much lower levels than they otherwise would be. Based on calculations from our term premia model, term premia has averaged about -22 bps since the global financial crisis versus a pre-crisis average of about +25 bps. This means the yield curve is about 47 bps flatter than ordinary if we adjust for the technical factors related to the impact QE had on term premia.

What signal is today's flattening yield curve sending?

We can draw a few conclusions about the current yield curve flattening, the main one being that it sends a weaker predictive signal about the future state of the U.S. economy than it has in the past. It's not different this cycle and we believe the yield curve still remains a good measure of the relationship between how monetary policy actions that influence the short end of the curve are impacting future expected growth and inflation dynamics that influence the long end of the curve. While we care about the flattening yield curve, we're not worried about an impending recession as we believe that today the slope of the yield curve sends a weaker signal and it would therefore take more flattening than ordinary to have the same impact on future growth than it had in the past.

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[1] Source: U.S. Federal Reserve, Bloomberg. Data shown is from 1990-2018.

[2] Source: Summary of Economic Projections from the U.S. Federal Reserve, Bloomberg. Data shown is from 1990 to June 13, 2018.

[3] Term premia is defined as a measure of risk compensation, typically from inflation, such that investors demand a higher yield for longer-dated U.S. Treasury bonds versus those of shorter maturities. As a result, yield curves generally have a positive slope. The measure of this slope is related to term premia.

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